36

How To Treat Foreign Earned Income

There is a tax incentive for working abroad—up to $70,000 of income earned abroad may escape U.S. income taxes and you may be entitled to an exclusion or deduction for certain housing costs. In measuring the economic value of this tax savings, consider the extra cost of living abroad. In some areas, the high cost of living and currency exchange rates will erode your tax savings and may make the position economically unfeasible.

The exclusion does not apply to investment income or to any other earned income that does not meet the exclusion tests.

To claim a foreign income exclusion you must satisfy a foreign residence or physical presence test.

Employees of the U.S. Government may not claim an exclusion based on the government pay earned abroad.

¶36.1 Claiming the Foreign Earned Income Exclusion

You must file a U.S. return if your gross income *exceeds* the filing threshold for your personal status, even though all or part of your foreign earned income may be tax free. The exclusion is not automatic; you must elect it. You elect the foreign earned income exclusion on Form 2555, which you attach to Form 1040. The housing cost exclusion (¶36.3) is also elected on Form 2555.

You may file simplified Form 2555-EZ if your 1996 foreign wages are $70,000 or less, you do not have self-employment income, and you do not claim the foreign housing exclusion, housing deduction, and business or moving expenses.

A separate exclusion is allowed for the value of meals and lodging received by employees living in qualified camps; *see* ¶36.8.

If you claim the foreign earned income exclusion of $70,000, you may not:

- Claim business deductions allocable to the excluded income;
- Make a deductible IRA contribution based on the excluded income; or
- Claim foreign taxes, paid on excluded income, as a credit or deduction.

In deciding whether to claim the exclusion, compare the overall tax (1) with the exclusion; and (2) without the exclusion but with the full foreign tax credit and allocable deductions. Choose whichever gives you the lower tax; *see* ¶36.2 and ¶36.6.

Once you elect the exclusion, that election remains in effect for all future years unless you revoke it. If you revoke the election, you cannot elect the exclusion again during the next five years without IRS consent. A revocation is made in a statement attached to your return for the year you want it to take effect. The foreign earned income exclusion and the housing cost exclusion must be revoked separately.

CAUTION — Claiming Foreign Tax Credit Revokes Prior Election

If you have been claiming the $70,000 exclusion and decide that it would be advantageous this year to forego the exclusion and instead claim the foreign tax credit for foreign earned income, be aware that claiming the credit is treated by the IRS as a revocation of the prior exclusion election. You cannot claim a credit for the next five years unless the IRS allows you to reelect the exclusion.

Claiming a foreign tax credit also may revoke a prior election to claim the housing cost exclusion. Depending on the foreign earned income in the year the credit is claimed, the credit may be considered a revocation of a prior earned income exclusion election and also a prior housing cost exclusion election, or as a revocation of only one of the elections.

A good faith error in calculating foreign earned income that leads to claiming a foreign credit will not be treated as a revocation of prior elections.

¶36.2 Qualifying for the Foreign Earned Income Exclusion

You may elect the exclusion for foreign earned income only if your tax home is in a foreign country *and* you meet either the foreign residence test *or* the foreign physical presence test of 330 days. The tests are discussed at ¶36.5. Tax home is discussed at ¶20.6. If your tax home is in the U.S., you may not claim the exclusion but may claim the foreign tax credit and your living expenses while away from home if you meet the rules at ¶20.9 for temporary assignments *expected* to last one year or less. U.S. government employees may not claim either the earned income exclusion or housing exclusion based on government pay.

Exclusion prorated on a daily basis. If you qualify under the foreign residence or physical presence test for only part of 1996, the $70,000 exclusion limit is reduced on a daily basis.

EXAMPLES

1. You were a resident of France from February 20, 1994, until June 30, 1996. On July 1 you returned to the U.S. Since your period of foreign residency included all of 1995, thereby satisfying the foreign residence test, you may claim a prorated exclusion for 1996. As you were abroad for 182 of the 366 days in 1996, you exclude earnings up to $^{182}/_{366}$ of the $70,000 maximum exclusion. If you earned $60,000 from January through June 1996, you would exclude $34,809 ($70,000 × $^{182}/_{366}$).
2. You worked in France from June 1, 1995, through September 30, 1996. Your only days outside France were a 15-day vacation to the U.S. in December 1995. You do not qualify for an exclusion under the foreign residence test because you were not abroad for a full taxable year; you were not abroad for either the full year of 1995 or 1996. However, you *do* qualify under the physical presence test; you were physically present abroad for at least 330 full days during a 12-month period. The 12-month period giving you the largest 1996 exclusion is the 12-month period starting October 21, 1995, and ending October 20, 1996. *See* ¶36.5 for figuring the 12-month period. Since you were abroad for at least 330 full days during that 12-month period, you may claim an exclusion. In 1996, you were abroad for 294 days within the 12-month period (January 1 to October 20, 1996, is 294 days). Thus, you exclude earnings up to $^{294}/_{366}$ of the maximum exclusion. If your earnings in France for 1996 were $80,000, your exclusion is limited to $56,230 ($70,000 × $^{294}/_{366}$).

If you are married and you and your spouse each have foreign earned income and meet the foreign residence or physical presence test, you may each claim a separate exclusion. If your permanent home is in a community property state, your earned income is not considered community property for purposes of the exclusion.

Foreign earnings from a prior year. Foreign income earned in a prior year but paid in 1996 does not qualify for the 1996 exclusion.

However, if the income was attributable to foreign services performed in 1995, the pay is tax free in 1996 provided you did not use the full 1995 exclusion of $70,000. Under another exception, payments received in 1996 for 1995 services are treated as 1996 income if the payment was within a normal payroll period of 16 days or less that included the last day of 1995. If the services were performed before 1995, no exclusion is available to shelter the pay.

Income for services performed in the U.S. does not qualify for the exclusion, even though it is paid to you while you are abroad.

Foreign tax credit. Foreign taxes paid on tax-free foreign earned income do not qualify for a credit or deduction. But if your foreign pay exceeds $70,000, you may claim a foreign tax credit or deduction for the foreign taxes allocated to taxable income. The instructions to Forms 2555 and 1116 and IRS Publication 514 provide details for making the computation.

Countries subject to travel restrictions. You may not claim the exclusion if you work in a country subject to U.S. government travel restrictions. You are not treated as a bona fide resident of, or as present in, a country subject to the travel ban. Libya, Cuba, and Iraq are within this ban. Check Form 2555 for changes to this list.

¶36.3 How To Treat Housing Costs

The housing costs of employees and self-employed persons are treated differently by the tax law. Employees get a housing exclusion; self-employed persons get a deduction from *taxable* foreign earned income. If you live in a special camp provided by your employer, all housing costs are excluded; *see* ¶36.8.

Exclusion for employer-financed housing costs. If the total of your foreign wage or salary income plus the value of employer-financed housing costs in 1996 does not exceed $70,000, both parts of your pay package are tax free. Your housing costs are considered to be employer-financed as long as they are covered by salary, employer reimbursements, a housing allowance, or if they are paid directly by your employer. If wages plus employer-financed housing exceed $70,000, a special housing exclusion will shelter part of your housing costs from tax. The housing exclusion is the difference between the employer's payment of reasonable housing expenses and a "base housing amount." The base housing amount is 16% of the salary for a U.S. government employee at the GS-14, Step 1 level as of the beginning of the year (the 1996 base amount may be found in Form 2555). If you qualify under the foreign residence or physical presence test for only part of 1996, the base housing amount is reduced on a daily basis. Follow instructions to Form 2555. The housing cost exclusion is elected on Form 2555. Employer-financed housing payments exceeding this housing cost exclusion may also escape tax if your foreign salary is below the maximum foreign earned income exclusion. That part of the foreign earned income exclusion not applied to your salary may be applied to housing costs; *see* Example 1 in the next column.

On Form 2555, you figure the housing exclusion before the foreign income exclusion. The income exclusion is limited to the excess of foreign earned income over the housing exclusion.

EXAMPLES

1. In 1996, your salary for work abroad is $57,808 and your employer pays $12,892 for your housing. On Form 2555, you list $70,700 (salary *plus* housing) as your foreign earned income. Assume that the housing cost exclusion is $3,650 (housing costs of $12,892 exceeding a base housing amount of $9,242). Your earned income exclusion is $67,050: $70,700 earned income *less* $3,650 housing exclusion.
2. In 1996, you earn a salary of $60,325 abroad and your employer pays $12,892 for your housing. Assume the housing exclusion is $3,650 (housing costs of $12,892 exceeding a base housing amount of $9,242). All of your salary plus the full amount of the housing costs avoids tax: the housing cost exclusion of $3,650 and an earned income exclusion of $69,567 ($73,217 foreign earned income *less* $3,650 housing exclusion).
3. Same as Example 2 above, except that you earn $64,325. Foreign earned income is $77,217 ($64,325 *plus* $12,892), but the total amount of income not subject to tax is $73,650. The total tax-free amount is made up of the housing cost exclusion of $3,650 and the maximum foreign earned income exclusion of $70,000.

Reasonable housing expenses. Include rent, utilities other than telephone costs, insurance, parking, furniture rentals, and repairs for yourself, your spouse, and dependents living with you. The following expenses do not qualify: cost of purchasing a home, furniture, or accessories; home improvements; payments of mortgage principal; domestic labor; and depreciation on a home or on improvements to leased housing. Furthermore, interest and taxes which are otherwise deductible do not qualify for the exclusion.

You may include the costs of a separate household that you maintain outside the U.S. for your spouse and dependents because living conditions at your foreign home are adverse.

Self-employed persons. On Form 2555, self-employed individuals may claim a limited deduction for housing costs exceeding the base housing amount. You may claim this deduction only to the extent it offsets taxable foreign earned income. The deduction is claimed as an "adjustment to income" on Line 30 of Form 1040, even if you do not itemize deductions.

Where you may not deduct expenses because you do not have taxable foreign earned income, expenses may be carried forward one year and deducted in the next year to the extent of taxable foreign earned income.

If you are an employee and self-employed during the same year. Housing expenses above the base amount are partly excludable and partly deductible. For example, if half of your foreign earned income is from services as an employee, half of the excess housing expenses over the base amount are excludable. The remaining

excess housing costs are deductible to the extent of taxable foreign earned income. Follow the instructions to Form 2555.

Countries ineligible for tax benefits. Housing expenses incurred in a country subject to a U.S. government travel restriction are not eligible for the tax benefits explained in this section. *See* Form 2555 instructions for a list of countries to which travel restrictions apply.

¶36.4 What Is Foreign Earned Income?

Earned income includes salaries, wages, commissions, professional fees, and bonuses. Earned income also includes allowances from your employer for housing or other expenses, as well as the value of housing or a car provided by the employer. It may also include business profits, royalties, and rents, provided this income is tied to the performance of services. Earned income does not include pension or annuity income, payments for nonqualified employee trusts or nonqualified annuities, dividends, interest, capital gains, gambling winnings, alimony, or the value of tax-free meals or lodging under the rules at ¶3.11. Foreign earned income does not include amounts earned in countries subject to U.S. government travel restrictions.

Foreign earned income eligible for the exclusion must be received no later than the taxable year after the year in which you perform the services. Pay is excludable in the year of receipt if you did not use the full exclusion in the year of the services.

U.S. government pay ineligible. If you are an employee of the U.S. government or its agencies, you may *not* exclude any part of your pay from your government employer. Courts have agreed with the IRS that U.S. government workers were U.S. employees even though they were paid from sources other than Congressionally appropriated funds. If you are not an employee of the U.S. government or any of its agencies, your pay is excludable even if paid by a government source. You are not an employee of the U.S. if you work under a contract made between your employer and the government.

Under a special law, tax liability is waived for a civilian or military employee of the U.S. government killed in a military action overseas; *see* ¶35.6.

Profits from sole proprietorship or partnership. If your business consists solely of services (no capital investment), 100% of gross income is considered earned income. If services and capital are both income-producing factors, no more than 30% of your net profit may be considered earned income.

If you do not contribute any services to a business (for example, you are a "silent partner"), your share of the net profits is *not* earned income.

EXAMPLES

1. A U.S. citizen resides in England. He invests in an English partnership that sells manufactured goods outside the U.S. He performs no services for the business. His share of net profits does not qualify as earned income.
2. Same facts as in Example 1, except he devotes his full time to the partnership business. Then 30% of his share of the net profits qualifies as earned income. Thus, if his share of profits is $50,000, earned income is $15,000 (30% of $50,000), assuming the value of his services is at least $15,000.
3. You and another person are consultants, operating as a partnership in Europe. Since capital is not an income-producing element, the entire gross income of the business is earned income.

The partnership agreement generally determines the tax status of partnership income in a U.S. partnership with a foreign branch. Thus, if the partnership agreement allocates foreign earnings to partners abroad, the allocation will be recognized unless it lacks substantial economic effect.

Fringe benefits. The value of fringe benefits, such as the right to use company property and facilities, is added to your compensation when figuring the amount of your earned income.

Royalties. Royalties from articles or books are earned income if you receive them for transferring all of your rights to your work, or you have contracted to write the articles or book for an amount in cash plus a royalty on sales.

Royalties from the leasing of oil and mineral lands and from patents are not earned income.

Rental income. Rental income is generally not earned income. However, if you perform personal services, for example as an owner-manager of a hotel or rooming house in a foreign country, then up to 30% of your net rents may be earned income.

Reimbursement of employee expenses. Do not include reimbursement of expenses as earned income to the extent they equal expenses which you adequately accounted for to your employer; *see* ¶20.31. If your expenses exceed reimbursements, the excess is allocated according to the rules in ¶36.6. If reimbursements exceed expenses, the excess is treated as earned income.

Straight commission salespersons or other employees who arrange with their employers, for withholding purposes, to consider a percentage of their commissions as attributable to their expenses treat such amounts as earned income.

Reimbursed moving expenses. Reimbursements of moving expenses are not reported as income if you adequately account to your employer for the expenses; *see* ¶21.6.

A reimbursement is taxable if received under a nonaccountable plan or for moving expenses that you deducted in an earlier year. However, for purposes of claiming the earned income exclusion, the reimbursement may be considered to have been earned in a year other than the year of receipt. This is important because an exclusion is allowed only for the year income is earned. If the move is from the U.S. to a foreign country, the reimbursement is considered foreign earned income in the year of the move if you qualify under the foreign residence or physical presence test for at least 120 days during that tax year. Reimbursement of moving expenses from one foreign country to another is considered foreign earned income in the year

of the move, if you qualify under the residency or physical presence test at the new location for at least 120 days during the tax year. If you do not meet one of these tests in the year of the move, the reimbursements are earned income which must be allocated between the year of the move and the following tax year.

A taxable reimbursement for a move back to the U.S. is considered income from U.S. sources if you continue to work for the same employer. If you move back to the U.S. and take a job with a new employer *or* if you retire and move back to the U.S. and your old employer reimburses your moving expenses under a prior written agreement or company policy, the reimbursement is considered to be for past services in the foreign country and qualifies as foreign earned income eligible for the exclusion. The reimbursement is considered earned in the year of the move if you qualified under the residency or physical presence test (¶36.5) for at least 120 days during the tax year. Otherwise, the reimbursement is allocated between the year of the move and the year preceding the move. *See* IRS Publication 54 for details.

¶36.5 Meeting the Foreign Residence or Physical Presence Test

To qualify for the foreign earned income exclusion, you must be either a U.S. citizen meeting the foreign residence test or a U.S. citizen or resident meeting the physical presence test in a foreign country. The following areas are not considered foreign countries: Puerto Rico, Virgin Islands, Guam, Commonwealth of the Northern Mariana Islands, American Samoa, or the Antarctic region.

If war or civil unrest prevented you from meeting the foreign residence or physical presence test, you may claim the exclusion for the period you actually were a resident or physically present abroad. Foreign locations and the time periods which qualify for the waiver of the residency and physical presence tests are listed in the instructions to Form 2555.

If, by the due date of your 1996 return (April 15, 1997), you have not yet satisfied the foreign residence or physical presence test, but you expect to meet either test after the filing date, you may either file on the due date and report your earnings or ask for a filing extension under the rules at ¶36.7.

Foreign residence test. You must be a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes one full tax year; a full tax year is from January 1 through December 31 for individuals who file on a calendar-year basis. Business or vacation trips to the U.S. or another country will not disqualify you from satisfying the foreign residence test. If you are abroad more than one year but less than two, the entire period qualifies if it includes one full tax year.

EXAMPLE

You are a bona fide foreign resident from September 30, 1995, to March 25, 1997. The period includes your entire 1996 tax year. Therefore, up to $70,000 of your 1996 earnings is excludable. Your overseas earnings in 1997 will qualify for a proportionate part of the exclusion in 1997.

To prove you are a foreign resident, you must show your intention to be a resident of the foreign country. Evidence tending to confirm your intention to stay in a foreign country is: (1) your family accompanies you; (2) you buy a house or rent an apartment rather than a hotel room; (3) you participate in the foreign community activities; (4) you can speak the foreign language; (5) you have a permanent foreign address; (6) you join clubs there; or (7) you open charge accounts in stores in the foreign country.

Residence does not have the same meaning as *domicile*. Your domicile is a permanent place of abode; it is the place to which you eventually plan to return wherever you go. You may have a residence in a place other than your domicile. Thus, you may go, say, to Amsterdam, and take up residence there and still intend to return to your domicile in the U.S. But your leaving your domicile does not, by itself, establish a bona fide residence in a new place. You must intend to make a new place your residence.

You will not qualify if you take inconsistent positions toward your foreign residency. That is, you will *not* be treated as a bona fide resident of a foreign country if you have earned income from sources within that country, filed a statement with the authorities of that country that you are not a resident there, and have been held not subject to the income tax of that country. However, this rule does not prevent you from qualifying under the physical presence test.

If you cannot prove that you are a resident, check to determine if your stay qualifies under the physical presence test.

Physical presence test. To qualify under this test, you must show you were on foreign soil 330 days (about 11 months) during a 12-month period. Whether you were a resident or a transient is of no importance. You have to show you were physically present in a foreign country or countries for 330 full days during any 12-consecutive-month period. The 12-month period may begin with any day. There is no requirement that it begin with your first full day abroad. It may begin before or after arrival in a foreign country and may end before or after departure from a foreign country. A *full* day is from midnight to midnight (24 consecutive hours). You must spend each of the 330 days on foreign soil. In departing from U.S. soil to go directly to the foreign country, or in returning directly to the U.S. from a foreign country, the time you spend on or over international waters does not count toward the 330-day total.

EXAMPLES

1. On August 9, you fly from New York City to Paris. You arrive there at 10 A.M. August 10. Your first full qualifying day toward the 330-day period is August 11.

   You may count in your 330-day period:

   - Time spent traveling between foreign countries.
   - Time spent on a vacation in foreign countries. There is no requirement that the 330 days must be spent on a job.
   - Time spent in a foreign country while employed by the U.S. government counts towards the 330-day test, even though pay from the government does not qualify for the earned income exclusion.

- Time in foreign countries, territorial waters, or travel in the air over a foreign country. However, you will lose qualifying days if any part of such travel is on or over international waters and takes 24 hours or more, or any part of such travel is within the U.S. or its possessions.

2. You depart from Naples, Italy, by ship on June 10 at 6:00 P.M. and arrive at Haifa, Israel, at 7:00 A.M. on June 14. The trip exceeded 24 hours and passed through international waters. Therefore, you lose as qualifying days June 10, 11, 12, 13, and 14. Assuming you remain in Haifa, Israel, the next qualifying day is June 15.

Choosing the 12-month period. You qualify under the physical presence test if you were on foreign soil 330 days during any period of 12 consecutive months. Since there may be several 12-month periods during which you meet the 330-day test, you should choose the 12-month period allowing you the largest possible exclusion if you qualify under the physical presence test for only part of 1995.

EXAMPLE

You worked in France from June 1, 1995, through September 30, 1996, and the next day you left the country. During this period, you left France only for a 15-day vacation to the U.S. during December 1995. You earned $80,000 for your work in France during 1996. Your maximum 1996 exclusion is $56,421, figured as follows:

1. Start with your last full day, September 30, 1996, and count back 330 full days during which you were abroad. Not counting the vacation days, the 330th day is October 22, 1995. This is the first day of your 12-month period.
2. From October 22, 1995, count forward 12 months to October 21, 1996, which is the last day of your 12-month period.
3. Count the number of days in 1996 which fall within the 12-month period ending October 21, 1996. Here, the number of qualifying days is 295, from January 1 through October 21, 1996.
4. The maximum 1996 exclusion is $70,000 × $\frac{295}{366}$, or $56,421. You may exclude $56,421, the lesser of the maximum exclusion and your actual earnings of $80,000.

¶36.6 Claiming Deductions

You may not deduct expenses that are allocable to the foreign earned income and housing exclusions. If you elect the earned income exclusion, you deduct expenses as follows:

Personal or nonbusiness deductions, such as medical expenses, mortgage interest, and real estate taxes paid on a personal residence, are deductible if you itemize deductions. Business expenses that are attributable to earning excludable income are not deductible. Dependency exemptions are fully deductible; *see* Example 1 in the next column.

If your foreign earnings exceed the exclusion ceiling, you allocate expenses between taxable and excludable income and deduct the amount allocated to taxable earned income; *see* Example 2 below.

EXAMPLES

1. You were a resident of Denmark and elect to exclude your wages of $70,000 from income. You also incurred unreimbursed travel expenses of $2,000. You may not deduct the travel expenses, since the amount is attributable to the earning of tax-free income.
2. You earn wages of $100,000 and satisfy the physical presence test. Your unreimbursed travel expenses for 1996 are $5,000, after reducing meals and entertainment by 50%. If you elect the $70,000 exclusion, 30% of the travel expenses, or $1,500, attributable to the taxable 30% of earnings, may be claimed as a miscellaneous itemized deduction subject to the 2% AGI floor.

If your job expenses are reimbursed and the expenses are adequately accounted for to your employer (¶20.30), the reimbursements are not reported as income on your Form W-2. If the reimbursement is less than expenses, the excess expenses are allocated as in Example 2 above.

You may have to allocate state income taxes paid on your income.

If either you or your spouse elects the earned income or housing exclusion, you may not claim an IRA deduction based on excluded income.

Overseas moving expenses. These expenses are generally treated as related to your foreign earnings. Thus, if you move to a foreign country and exclude your income, you may not deduct your moving expenses. If your earned income exceeds the exclusion limit, you allocate moving expenses between your tax-free and taxable earned income.

If you were reimbursed by your employer under a nonaccountable plan, or if the reimbursement is for expenses that you deducted in an earlier year, the reimbursement is considered earned income in the year of receipt and is added to other earned income before taking the exclusion and making the allocation. *See* ¶36.4 for allocating reimbursements between the year of the move and the following year for purposes of claiming the exclusion.

If, after working in a foreign country, your employer transfers you back to the U.S. or you move back to the U.S. to take a different job, your moving expenses are deductible under the general rules of Chapter 21. If your residence and principal place of work was outside the U.S. and you retire and move back to the U.S., your moving expenses are also deductible, except that you do not have to meet the 39-week test for employees or the 78-week test for the self-employed and partners.

Survivors of workers abroad returning to U.S. If you are the spouse or dependent of a worker who died while his or her principal place of work was outside the U.S., you may deduct your moving expenses back to the U.S. For the costs to be deductible, the move

must begin within six months of the worker's death. The requirements for deducting moving expenses apply, except for the 39-week test for employees or the 78-week test for the self-employed and partners.

Compulsory home leave. Foreign service officers stationed abroad must periodically return to the U.S. to reorient themselves to American ways of life. Because the home leave is compulsory, foreign service officers may deduct their travel expenses; travel expenses of the officer's family are not deductible.

¶36.7 Exclusion Not Established When Your Return Is Due

When your 1996 return is due, you may not have been abroad long enough to qualify for the exclusion. If you expect to qualify under either the residence or physical presence test after the due date for your 1996 return, you may either (1) ask for an extension of time for filing your return on Form 2350 until after you qualify under either rule; or (2) file your return on the due date, reporting the foreign income in the return, pay the full tax, and then file for a refund when you qualify.

If you will have tax to pay even after qualifying for the exclusion—for example, your earned income exceeds the exclusion—you may file for an extension to file but you will owe interest on the tax due. To avoid interest charges on the tax, you may take one of the following steps:

1. File a timely return and pay the total tax due without the application of the exclusion. When you do qualify, make sure you file a refund claim within the time limits discussed at Chapter 38; *or*
2. Pay the estimated tax liability when you apply for the extension to file on Form 2350. If the extension is granted, the payment is applied to the tax shown on your return when you file.

Extension of Time To File

If you are living and working abroad on April 15, 1997, you have an automatic extension to June 16, 1997. For an additional two months, file Form 4868 by June 16, 1997, and pay an estimated tax. For a longer extension, in anticipation of owing no tax on your foreign income, you may file Form 2350 either with the Internal Revenue Service, Philadelphia, Pennsylvania 19255, or with a local IRS representative. File Form 2350 before the due date for filing your 1996 return, which is June 16, 1997, if you are abroad and are on a calendar year. If you cannot get Form 2350, apply for the extension on your own stationery. State the facts you rely on to justify the extension and the earliest date you expect to be in a position to determine under which rule you will qualify. You will receive an official letter and copy granting the extension. Generally, you will be granted an extension for a period ending 30 days after the date you expect to qualify for the foreign earned income exclusion.

¶36.8 Tax-Free Meals and Lodging for Workers in Camps

If you must live in a camp provided by your employer, you may exclude from income the value of the lodging and meals furnished if the camp is (1) provided because you work in a remote area where satisfactory housing is not available; (2) located as near as is practical to the worksite; and (3) a common area not open to the public normally accommodating at least 10 employees.

You also may qualify for the earned income exclusion.

¶36.9 Virgin Islands, Samoa, Guam, Northern Marianas

The Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands have their own independent tax departments. Therefore, contact the particular tax authority for the proper treatment of your income and ask the IRS for the 1996 edition of Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions.* If you have a mailing address overseas, get Publication 570 by writing to the Eastern Area Distribution Center, P.O. Box 25866, Richmond, VA 23286-8107.

For tax information from Guam, write to Department of Revenue and Taxation, Government of Guam, Building 13-1 Mariner Avenue, Tiyjan Barrigada, Guam 96913. For information from the Commonwealth of the Northern Mariana Islands, write to the Division of Revenue and Taxation, Commonwealth of the Northern Mariana Islands, P.O. Box 5234, CHRB, Saipan, Northern Mariana Islands 96950. For information from American Samoa, write to the Tax Division, Government of American Samoa, Pago Pago, American Samoa 96799. Also *see* IRS Publication 570.

For information about tax liability in the Virgin Islands, write to Virgin Islands Bureau of Internal Revenue, 9601 Estate Thomas, Charlotte Amalie, St. Thomas, U.S. Virgin Islands 00802. Also *see* IRS Publication 570.

Possession exclusion. At the time this book went to press, a possession exclusion applied to bona fide residents of American Samoa. On Form 4563, such residents may exclude for U.S. tax purposes their income from sources in American Samoa, Guam, and the Commonwealth of the Northern Marianas and income effectively connected with a business in these possessions.

¶36.10 Earnings in Puerto Rico

If you are a U.S. citizen who is also a resident of Puerto Rico for the entire year, you generally report all of your income on your Puerto Rico tax return. Where you report income from U.S. sources on the Puerto Rico tax return, a credit against the Puerto Rico tax may be claimed for income taxes paid to the United States.

If you are not a resident of Puerto Rico, you report on a Puerto Rico return only income from Puerto Rican sources. Wages earned for services performed in Puerto Rico for the U.S. government or for private employers are treated as income from Puerto Rican sources.

Information on Puerto Rico tax returns may be requested from Department of the Treasury Bureau of Income Tax, Consulting and Legislation Office, P.O. Box 2501, San Juan, Puerto Rico 00902-2501.

U.S. tax returns. As a U.S. citizen, you must file a U.S. tax return reporting income from all sources. But if you are a bona fide resident of Puerto Rico for an entire tax year, you do not report on a U.S. tax return any income earned in Puerto Rico during your residence there, except amounts received for services performed in Puerto Rico as an employee of the U.S. government. Similar rules apply if you have been a bona fide resident of Puerto Rico for at least two years before changing your residence from Puerto Rico. On a U.S. tax return, you may not deduct expenses or claim tax credits allocable to the excludable income. Personal exemptions are fully deductible.

If you are not a bona fide resident of Puerto Rico for the entire tax year, or were not a bona fide resident for two years prior to the tax year, you report on your U.S. tax return all income you earned in Puerto Rico, as well as all income from other sources. If you are required to report income earned in Puerto Rico on your U.S. tax return, you may claim a credit for income tax paid to Puerto Rico. You figure the credit on Form 1116.

EXAMPLE

You and your spouse are bona fide residents of Puerto Rico during the entire year of 1996. You receive $25,000 in wages as an employee of the U.S. government working in Puerto Rico, a $100 dividend from a Puerto Rican corporation that does business in Puerto Rico, and a $500 dividend from a U.S. corporation that does business in the U.S. Your spouse earned $18,000 in wages from a Puerto Rican corporation for services performed in Puerto Rico. Your exempt and taxable income for U.S. federal tax purposes is as follows:

	Taxable	*Exempt*
Your wages	$25,000	
Your spouse's wages		$18,000
Puerto Rican corporation dividend		100
U.S. corporation dividend	500	
Totals	$25,500	$18,100

You file tax returns with both Puerto Rico and the U.S. You have gross income of $25,500 for U.S. tax purposes and $43,600 for Puerto Rican tax purposes. A tax credit may be claimed on the U.S. tax return for income taxes paid to Puerto Rico and on your Puerto Rico return for income taxes paid to the U.S on U.S. source income.

¶36.11 Tax Treaties with Foreign Countries

Tax treaties between the United States and foreign countries modify some of the rules discussed in this chapter. The purpose of the treaties is to avoid double taxation. Consult your tax advisor about the effect of these treaties on your income. IRS Publication 54 contains a list of tax treaties.

¶36.12 Exchange Rates and Blocked Currency

Income reported on your federal income tax return must be stated in U.S. dollars. Where you are paid in foreign currency, you report your pay in U.S. dollars on the basis of the exchange rates prevailing at the time the income is actually or constructively received. You use the rate that most closely reflects the value of the foreign currency—the official rate, the open market rate, or any other relevant rate. You may even be required to use the black market rate if that is the most accurate measure of the actual purchasing power of U.S. dollars in the foreign country. Be prepared to justify the rate you use.

Currency gains and losses. A special statute, Section 988, governs the treatment of gain or loss on currency transactions. In the case of individuals, Section 988 applies if expenses attributable to the transaction would be deductible as business expenses or expenses for the production of income.

Fulbright grants. If 70% of a Fulbright grant is paid in nonconvertible foreign currency, U.S. tax may be paid in the foreign currency. *See* IRS Publication 520 for details.

Blocked currency. A citizen or resident alien may be paid in a foreign currency that cannot be converted into American dollars and removed from the foreign country. If your income is in blocked currency, you may elect to defer the reporting of that income until (1) The currency becomes convertible into dollars. (2) You actually convert it into dollars. (3) You use it for personal expenses (for example, in the foreign country when you go there). Purchase of a business or investment in the foreign country is not the kind of use that is treated as a conversion. (4) You make a gift of it or leave it in your will. (5) You are a resident alien and you give up your U.S. residence.

If you use this method to defer the income, you may not deduct the expenses of earning it until you report it. You must continue to use this method after you choose it. You may only change with permission of the IRS.

You do not defer the reporting of capital losses incurred in a country having a blocked currency.

There may be these disadvantages in deferring income:

- Many years' income may accumulate and all be taxed in one year.
- You have no control over the year in which the blocked income becomes taxable. You usually cannot control the events that cause the income to become unblocked.

You choose to defer income in blocked currency by filing a tentative tax return reporting your blocked taxable income and explain that you are deferring the payment of income tax because your income is not in dollars or in property or currency which is readily convertible into dollars. You must attach to your tentative return a regular return, reporting any unblocked taxable income received during the year or taxable income which became unblocked during the year. When the currency finally becomes unblocked or convertible into a currency or property convertible to dollars, you pay tax on the earnings at the rate prevailing in the year the currency became unblocked or convertible. On the tentative return, note at the top: "Report of Deferrable Foreign Income, pursuant to Revenue Ruling 74-351." File separate returns for each country from which blocked currency is received. The election must be made by the due date for filing a return for the year in which an election is sought.

¶36.13 Information Returns on Foreign Currency

If you have a financial interest in, signature, or other authority over a foreign bank account, a foreign securities account, or any other foreign financial account, you must report this fact on Form TDF 90-22.1 (Report of Foreign Bank and Financial Accounts) if the aggregate value of the accounts at any time during the year exceeds $10,000. The form does not have to be filed if the accounts were with a U.S. military banking facility operated by a U.S. financial institution. Taxpayers filing Form 1040 must also indicate on Schedule B whether they had an interest in a foreign account during the year. Form TDF 90-22.1 is not filed with your income tax return. The form must be filed by June 30 of the year following the year in which you had this financial interest. Foreign accounts for 1996 must be reported by June 30, 1997.

Treasury regulations impose reporting and record-keeping requirements for currency transfers to and from the U.S. Generally, transactions involving a physical transfer of funds or monetary instruments into or outside the U.S. must be reported if the amount involved exceeds $10,000 on any one occasion; *see* Form 4790.

Financial institutions must file a Form 4789 for each deposit, withdrawal, exchange of currency, or any other currency transaction of more than $10,000.

¶36.14 Foreign Tax Credit

You may claim an itemized deduction for qualified foreign taxes or you may claim a foreign tax credit. You must file Form 1116 to compute your credit. You may not claim a foreign tax credit or deduction for taxes paid on income not subject to U.S. tax. If all of your foreign earned income is excluded, none of the foreign taxes paid on such income may be taken as a credit or deduction on your U.S. return. If you exclude only part of your foreign pay, you determine which foreign taxes are attributable to excluded income and thus barred as foreign tax credits by applying the fractional computation provided in the instructions to Form 1116 and IRS Publication 514.

Choosing Credit or Deduction

If you qualify for a credit or deduction, you will generally receive a larger tax reduction by claiming a tax credit rather than a deduction. A deduction is only a partial offset against your tax, whereas a credit is deducted in full from your tax. Also, taking a deduction may bar you from carrying back an excess credit from a later year. However, a deduction may give you a larger tax saving if the foreign tax is levied at a high rate and the proportion of foreign income to U.S. income is small. Compute your tax under both methods and choose the one providing the larger tax reduction.

In one tax year, you may not elect to deduct some foreign taxes and claim others as a credit. One method must be applied to all taxes paid or accrued during the tax year. If you are a cash basis taxpayer, you may claim a credit for accrued foreign taxes, but you must consistently follow this method once elected.

The credit is the amount of foreign taxes paid or accrued, not to exceed the effective U.S. tax on foreign income multiplied by a ratio of foreign taxable income over total taxable income.

Credit disallowed. The credit may *not* be claimed if:

- You are a nonresident alien. However, under certain circumstances, an alien who is a bona fide resident for an entire taxable year in Puerto Rico may claim the credit. Also, a nonresident alien engaged in a U.S. trade or business may claim a credit if he or she receives income *effectively connected* to that business.
- You are a citizen of a U.S. possession (except Puerto Rico) but not a U.S. citizen or resident.

No credit is allowed for taxes imposed by a country designated by the government as engaging in terroristic activities; *see* IRS Publication 514 for a list of these countries.

Taxes qualifying for the credit. The credit is allowed only for foreign income tax, excess profits taxes, and similar taxes in the nature of an income tax. It is not allowed for any taxes paid to foreign countries on sales, gross receipts, production, the privilege to do business, personal property, or export of capital. But it may apply to a—

- Tax similar to a U.S. tax on income.
- Tax paid by a domestic taxpayer in lieu of the tax upon income, which would otherwise be imposed by any foreign country or by any U.S. possession.

- Tax of a foreign country imposing income tax, where for reasons growing out of the administrative difficulties of determining net income or basis within that country, the tax is measured by gross income, sales, and number of units produced.
- Pension, unemployment, or disability funds of a foreign country; certain foreign social security taxes do not qualify.

Reporting foreign income on your return. You report the gross amount of your foreign income in terms of United States currency. You also attach a schedule showing how you figured the foreign income in United States currency.

EXAMPLE

You earn Canadian dividends of $100 (Canadian dollars), from which $15 of Canadian taxes were withheld. When the dividends were declared, a Canadian dollar could be exchanged for $.78 of United States currency. Therefore, the dividend of $100 (in Canadian dollars) is reported on your return as $78 ($100 × .78). The tax withheld which may be taken as a credit is $11.70 ($15 × .78).

¶36.15 Computing the Foreign Tax Credit

The foreign tax credit is based on the amount of foreign taxes you paid or accrued, subject to this overall limitation which is figured on Form 1116:

$$\text{U.S. tax} \times \frac{\text{Taxable income from all foreign countries}}{\text{Taxable income from all sources}}$$

Separate limitation categories. The above fractional limitation must be figured separately for specific categories of foreign income. These categories are (1) passive income (such as dividends, interest, rents, royalties, and gains on certain commodity transactions; (2) foreign interest income subject to withholding at a rate of 5% or more; (3) shipping and aircraft related income; (4) lump-sum retirement distributions from foreign sources subject to special averaging; (5) certain income derived in banking, insurance, or financing businesses. Taxable income for each category must be separately computed and the overall limitation fraction applied. A separate computation also must be made for all other foreign income not within these categories; this "other" income group is called general limitation income. Follow the instructions to Form 1116 and *see* IRS Publication 514 for further details.

Recapture of foreign losses. If you sustain an "overall foreign loss" for any taxable year, a recapture provision treats part of foreign income realized in a later year as income from U.S. sources. By treating part of the later year's foreign income as U.S. income, the numerator of the fraction used to compute the overall limitation (*see* above) is reduced and this in turn reduces the maximum foreign tax credit that may be claimed in the later year. More specifically, the portion of foreign income in succeeding years which is treated as U.S. income equals the lower of (1) the amount of the loss, and (2) 50% (or a larger percentage, as you may choose) of taxable income from foreign sources. An "overall foreign loss" means the amount by which the gross income for the taxable year from foreign sources for that year is exceeded by the sum of allocated deductions. For this purpose, the following deductions are not subject to recapture: operating loss deductions, any uncompensated foreign expropriation, and casualty loss. Special rules apply to dispositions of property if used predominantly outside the United States in a trade or business. *See* IRS Publication 514 for recapture details.

Taxable income. Income which is tax free under the foreign earned income exclusion is not taken into account when figuring taxable income. Foreign taxable income, for purposes of computing the ratio, is reduced by all expenses directly related to earning the income. Itemized deductions, such as medical expenses, that are not directly related to foreign sources are allocated to foreign income according to relative gross incomes from foreign and U.S. sources. You do not consider personal exemptions when figuring foreign or total taxable income.

The foreign tax credit may not exceed foreign taxes actually paid or accrued. Where a joint return is filed, the limitation is applied to the aggregate taxable income of both spouses.

A limited foreign tax credit may be applied against the alternative minimum tax; *see* ¶23.9.

Capital gains. In figuring the overall limitation, taxable income from foreign countries (the numerator) includes gain from the sale of capital assets only to the extent of foreign source capital gain net income, which is the lower of net capital gain from foreign sources or net capital gain from all sources. Gain on the sale of nondepreciable personal property sold outside the country of your residence may be treated as gain from U.S. sources, unless the gain is subject to a foreign income tax at a rate of 10% or more of the gain. *See* instructions to Form 1116.

¶36.16 Carryback and Carryover of Excess Foreign Tax Credit

Where the amount allowable as a credit under the overall basis is restricted, the excess may be carried back to the two preceding years and then carried forward to the five succeeding taxable years. The carryback or carryover will not be allowed in a year you have no income from foreign sources or the credit limitation already applies to taxes of that year. For further details, *see* IRS Publication 514.